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Federal Communications Commission
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Regulatory Reform for	)	
Local Exchange Carriers	)	CC Docket No. 92-135
Subject to Rate of Return	)	
Regulation	)	

COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION

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August 28, 1992

TABLE OF CONTENTS

SUMMARY

USTA supports the Commission's efforts in this proceeding to bring incentives, tariff streamlining and decreased regulatory burdens to the nearly 1,300 LECs that remain under rate-of-return regulation. USTA is concerned, however, that without several fundamental changes to the Commission's proposals, the benefits of regulatory reform will not be achieved, and many carriers, including those in the NECA pools, could be seriously harmed.

With regard to the Commission's proposed optional incentive regulation plan, two changes are critical if the plan is to work at all, and several other changes are necessary to achieve the Commission's objectives in this proceeding and to ensure that the plan strikes a reasonable balance between the interests of carriers and their customers. First, the Commission must permit a LEC to participate under optional incentive regulation for its depooled traffic sensitive rates alone where the carrier remains in the NECA pool for common line. If a LEC must depool both its traffic sensitive and common line rates before the LEC can participate under the plan, few, if any, LECs will seek optional incentive regulation.

Only five non-price cap LECs have depooled both their traffic sensitive and common line rates. In contrast, 50 carriers have exited the traffic sensitive pool while remaining pooled for common line. These carriers, and those LECs in both pools, are unlikely to depool their common line rates because

such depooling would create a significant price disparity between their rates and the rates of neighboring pooled or non-pooled, but low-cost, carriers. Allowing LECs that remain in the common line pool to participate under the incentive plan for their depooled traffic sensitive rates will facilitate plan election by the largest number of carriers and, thus, will help achieve the Commission's objective of "maximizing the benefits" of the plan. This change to the Commission's proposal is also consistent with the Commission's goal to provide a regulatory "continuum" that accounts for the diversity among the many non-price cap carriers.

Second, the Commission must prescribe a sufficient earnings incentive to induce LECs to undertake the cost-saving and other efficiency steps intended by optional incentive regulation. The Commission's proposal to allow LECs to earn no more than 100 basis points above the authorized rate-of-return does not account fully for the substantial risks of participating under the plan. In determining the appropriate upper earnings level under the incentive plan, the Commission must recognize that every two years, the full benefits of any LEC efficiency gains will accrue to the LEC's customers as the LEC retargets its rates back to the authorized rate-of-return. With this in mind, an upper earnings limit of 200 basis points above the authorized level is entirely reasonable, and would provide the incentive necessary to achieve meaningful productivity improvement consistent with the plan's objectives.

USTA supports the Commission's proposal to allow pricing flexibility under optional incentive regulation. In order to minimize rate churn, however, the Commission should provide a means by which the rate relationships achieved through pricing flexibility during the incentive plan's two-year period can be preserved in subsequent periods. USTA proposes a rate adjustment factor which accomplishes a smooth transition between plan periods.

USTA also supports a flexible new service rule. To simplify and reduce the regulatory burdens on LECs involved in new service introductions, however, the Commission should modify its proposal and not require a cost-based filing within 12 months if the LEC continues to meet the *de minimis* revenue standard. Further, in addition to the 2% criterion proposed by the Commission, the rule should cover new services whose projected revenues are less than $200,000.

The Commission should modify its proposal that would require a LEC to meet a "heavy burden" if the LEC retargets its rates up to the lower earnings limit during the two-year period under optional incentive regulation. Such a requirement was not placed on price cap carriers, and is not appropriate for the generally smaller non-price cap LECs. The Commission should also modify its service quality reporting proposal to recognize the differences between optional incentive regulation and price caps, and eliminate the undue burdens that would be placed on smaller carriers by the price cap service quality reporting requirements.

When a LEC leaves optional incentive regulation, it should be permitted to file a single tariff for any affiliated companies, as is now permitted under the Commission's rules. A LEC should also be permitted to reenter, or enter for the first time, NECA's traffic sensitive pool. Such pool participation is not precluded by the Commission's rules for carriers under rate-of-return regulation. Although reentry to the NECA common line pool is ordinarily not permitted, the Commission should allow such reentry for small telephone companies (i.e., LECs with less than 50,000 access lines). This policy would mitigate part of the risk faced by these carriers due to their higher revenue variability, and would help to encourage participation by small LECs in optional plans for both traffic sensitive and common line rates.

With regard to both optional incentive regulation and the Commission's proposed extension of the Section 61.39 filing option to include common line rates, the common line demand adjustment formula proposed by the Commission should be rejected in favor of a demand adjustment that would equitably share the benefits of carrier common line demand growth between the LEC and its customers, and which would recognize the common line cost growth experienced by non-price cap LECs. USTA proposes a formula herein which incorporates these necessary features.

Finally, and perhaps most importantly, the Commission must not abandon prospective rate-making for baseline rate-of-return regulation. The Commission's proposal to rely on "simple extrapolations of historical costs and demand," or on "historical costs to support certain rate elements," would not allow baseline LECs and the NECA pools to account fully for future cost-intensive events, such as the implementation of Signalling System # 7 and 800 data base. The Commission's proposal would also bias long-term earnings results against these carriers. In sum, the Commission's proposed reform of baseline regulation could have a deleterious effect on the continued viability of the NECA pools and on LECs remaining under rate-of-return regulation.

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Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation	)	CC Docket No. 92-135

COMMENTS OF THE
UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association (USTA)[1] hereby comments on the issues raised by the Commission's Notice of Proposed Rulemaking (NPRM), FCC 92-258, released July 17, 1992.

I. INTRODUCTION.

In its Second Report and Order in the price cap proceeding, the Commission recognized that price cap regulation may not be appropriate for all local exchange carriers (LECs), particularly smaller ones.[2] For this reason, the Commission stated its intent to "initiate further proceedings dealing specifically with regulatory

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[1] USTA is the principal trade association of the exchange carrier industry. Its membership of approximately 1,100 local telephone companies represents over 98% of telephone company-provided local access lines.

[2] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6799 (1990) (Second Report and Order), modified on recon., 6 FCC Rcd 2637 (1991), petitions for further recon. dismissed, 6 FCC Rcd 7482 (1991).

issues of concern to small and midsize LECs."[3] The instant NPRM fulfills this intent.

As the Commission notes, in developing the regulatory reform proposals set forth in the NPRM, the Commission "worked closely with members of the LEC industry, NECA [the National Exchange Carrier Association], and interexchange carriers."[4] USTA, in particular, met with Commission staff on numerous occasions over the past year in an attempt to develop a set of regulatory reform initiatives that would achieve substantial benefits for LECs, the Commission's administrative processes and, most importantly, the LECs' customers. To this end, USTA presented the staff with a proposal for regulatory reform that included: (1) an optional incentive regulation plan for non-price cap LECs; (2) expansion of the Section 61.39[5] small company filing option to include common line rates; and (3) changes to, and streamlining of, "baseline" rate-of-return regulation applicable to the NECA pools and other LECs filing cost-based tariffs under Section 61.38 of the Commission's rules.[6] USTA's proposal recognized, as does the

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[3] Second Report and Order, 5 FCC Rcd at 6827.

[4] NPRM, ¶ 1, n. 2.

[5] 47 CFR § 61.39.

[6] 47 CFR § 61.38.

Commission,[7] the diverse nature of non-price cap LECs and the need to provide a "continuum" of regulatory approaches that permit LECs to select a plan which is best suited to their particular circumstances.[8]

The proposals contained in the NPRM share USTA's three-part approach to regulatory reform including optional incentive regulation, extension of Section 61.39 to include common line rates, and modifications to baseline regulation. The Commission's proposals also share a number of features with the plan discussed by USTA with Commission staff. In this regard, the NPRM is a first step toward achieving meaningful regulatory reform for the approximately 1,300 LECs that remain under rate-of-return regulation. Unfortunately, however, the NPRM contains several tentative conclusions and proposals which, if adopted, would discourage LECs from electing the incentive regulation plan, and could potentially harm the NECA pools and other LECs remaining under baseline regulation. For these reasons, and as further discussed below, USTA cannot support the NPRM

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[7] See NPRM ¶¶ 2, 3.

[8] USTA's proposal, and a supplement thereto proposing limited pricing flexibility under baseline regulation, including the NECA pools, were placed on the record in this proceeding by letter dated July 29, 1992, from Linda Kent, Associate General Counsel of USTA, to Donna Searcy, Secretary of the Commission.

without several important changes to the Commission's proposals.

Although USTA did not expect the NPRM to incorporate each idea that USTA had discussed with Commission staff, there are certain fundamental principles that must be part of any regulatory reform plan. Specifically, in contrast to the Commission's tentative views:

- Optional incentive regulation must be available to LECs that have depooled only their traffic sensitive rates, as well as to LECs that have depooled both their common line and traffic sensitive rates. Otherwise, few LECs would ever seek optional incentive regulation.

- The earnings parameters of optional incentive regulation must provide sufficient incentives if LECs are to implement the cost-saving efficiencies contemplated by the Commission. The Commission's proposal for an earnings range of 100 basis points below to 100 basis points above the authorized rate-of-return does not provide these incentives because it fails to account fully for the substantial risks inherent in optional incentive regulation.

- Baseline regulation must preserve fully prospective cost-based tariff filings for non-price cap LECs and the NECA pools. These carriers may fall short of earning their authorized rate-of-return under the Commission's proposal to derive cost and demand data through simple extrapolations, or to rely solely on historical data for certain rate elements.

These essential changes to the Commission's tentative proposals are discussed in detail below. These comments also present USTA's views on other issues raised by the NPRM including, _inter alia_, known and measurable changes, pricing flexibility, new service introduction, service quality reporting, tariff filing requirements, conditions under which LECs may exit optional incentive regulation, the carrier common line demand adjustment, and extension of the Section 61.39 filing option to include common line.

II. DISCUSSION.

A. Optional Incentive Regulation.

1. LECs Must Be Permitted to Elect Optional Incentive Regulation for Depooled Traffic Sensitive Rates Even If They Have Not Depooled Their Common Line Rates.

Although the Commission recognizes that small companies "may experience sufficient instability in their common line revenues to dissuade them from participating in the [optional incentive regulation] plan if . . . an all-or-nothing approach is employed," the Commission nonetheless tentatively concludes "that companies electing the incentive plan [must] develop and maintain both common line and traffic sensitive rates within the incentive plan rules."[9] The purported rationale for requiring a total depooling before a LEC and its affiliates can participate under the incentive plan,[10] is that such total depooling would "maximize the benefits" of the plan by making the LEC's

[9] NPRM, ¶ 24.

[10] There is an exception for average schedule study areas. Id. at ¶ 25.

total regulated interstate operations subject to the plan.[11]

USTA agrees that the benefits expected from optional incentive regulation will increase as more of a carrier's operations are placed under the plan. That reasoning, however, does not justify limiting the benefits of the incentive plan only to LECs who have completely exited the NECA pools, when substantial benefits can be realized for depooled traffic sensitive rates under circumstances where a LEC remains a member of the NECA common line pool.

An eligibility criterion which allows LECs to place all of their depooled traffic sensitive rates under the incentive plan, while they remain pooled for common line, will substantially increase plan participation and, thus, will achieve the Commission's stated objective to "maximize the benefits" of the plan. USTA understands that only five non-price cap LECs have depooled both their traffic sensitive and common line rates.[12] In contrast, approximately 50 LECs (including holding companies) have

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[11] Id. at ¶ 24. The Commission invites "parties urging adoption of a bifurcated approach (e.g., allowing participation for TS only)" to "provide data and information supporting their views." Id. USTA presents such data and information below.

[12] See Monitoring Report, Federal-State Joint Board, CC Docket 87-339, July 1992, p. 307. One of these companies, Centel, is scheduled to be merged with a price cap LEC and, thus, will not be eligible to elect optional incentive regulation.

depooled their traffic sensitive rates while remaining in the common line pool. While all of these LECs are not necessarily candidates for the plan, their eligibility significantly increases the likelihood of meaningful plan participation.

LECs are not likely to depool their common lines rates in order to participate under the plan. On average, NECA pool members' carrier common line rates would increase by over 300% on a depooled basis.[13] These LECs would be reluctant to depool their carrier common line rates because such action would create a significant price disparity between their rates and those of neighboring carriers that remain in the pool, or happen to be low-cost, non-pooled LECs. Moreover, depooled carrier common line rates could pressure IXCs to deaverage their toll rates, contrary to an important Commission policy objective.[14]

The Commission's tentative conclusion to require total depooling is also inconsistent with its observation that regulatory reform for small and midsize LECs should present

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[13] See Monitoring Report, supra, Chart 7.3. The substantial increases for depooled common line rates are not limited to the smallest LECs. Even some of the larger pooled carriers, such as the Puerto Rico Telephone Company and the ALLTEL companies, would experience rate increases of up to 400% on a depooled basis.

[14] See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 4 FCC Rcd 2874, 3132-33 (1989).

a continuum that accounts for the diversity among the many non-price cap carriers.[15] An all-or-nothing depooling requirement for optional incentive regulation represents a significant break in the continuum and fails to account for LECs who have depooled their traffic sensitive rates but remain in the NECA common line pool for a legitimate reason (i.e., to provide increased revenue stability) recognized by the Commission.[16] Perhaps the Commission's tentative position on this issue is influenced by its belief that optional incentive regulation "will serve as a transitional step for companies who eventually elect to participate in full price caps regulation."[17] While this may happen, the primary goal of optional incentive regulation should be to provide the benefits of the plan to the largest number of LECs along the regulatory continuum, regardless of whether those LECs eventually move to price caps, and, in turn to benefit ratepayers.

Further, the Commission's tentative conclusion on depooling is inconsistent with the goal of "pooling neutrality", which the Commission has recognized as a public interest objective in the context of the Section 61.39 small

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[15] See NPRM, ¶ 3.

[16] Id. at ¶ 24.

[17] Id. at ¶ 9.

company filing option.[18] A neutral impact on the NECA pools can hardly be maintained by a policy that requires LECs to leave all NECA pools (except for average schedule study areas) before LECs can participate under optional incentive regulation. (While price caps require total depooling,[19] the Bell Operating Companies, GTE and virtually all other companies that elected price caps had already depooled and, thus, pooling neutrality was never an issue under price caps.[20])

Permitting participation in the plan for depooled traffic sensitive rates alone (if the LEC participates in the NECA common line pool) will not allow a LEC to "game" the process. Under USTA's proposal, electing carriers would have to place all depooled services (traffic sensitive alone, or traffic sensitive plus common line) and all LEC affiliates (except average schedule affiliates) under the plan. Further, if a LEC leaves the plan, it cannot "return

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[18] See id. at ¶ 29.

[19] Second Report and Order, 5 FCC Rcd at 6818.

[20] In the price cap proceeding, the Commission apparently expected at least some pooled small and medium-sized LECs to leave all NECA pools and elect price cap regulation. See Second Report and Order, 5 FCC Rcd at 6819 (Commission delegates to the Chief, Common Carrier Bureau, the task of simplifying procedures to enable such LECs to more easily develop the rates and data needed to support their first price cap filing.) Of course, these carriers did not elect price caps and generally remained in the NECA pools.

to incentive regulation until the fourth year after the year in which it ceased its participation in incentive regulation."[21] Moreover, in addition to the review afforded by the Commission's accounting and tariffing procedures, a LEC's pool data would be subject to review by NECA. In view of the fact that a LEC's decision to continue in the NECA common line pool would be largely based on reasons unrelated to the incentive regulation plan, these safeguards should effectively preclude any chance of gaming or other abuse of the Commission's processes.[22]

In short, the Commission's proposal that a LEC must not be in any NECA pool before it can participate under optional incentive regulation will result in very few carriers electing the plan. This is hardly the way to maximize the benefits of the incentive plan. To ensure the broadest possible election of the plan by LECs, the Commission must modify its tentative conclusion and permit

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[21] NPRM, ¶ 26.

[22] It is noteworthy that the Commission has recognized the success of the Section 61.39 small company filing option which until now has permitted participation only for traffic sensitive rates. NPRM, ¶ 29. The Commission is now proposing that small LECs be able to elect the Section 61.39 option "for either traffic sensitive or both traffic sensitive and common line rate development". Id. at ¶ 35.

participation by those LECs who have exited only the NECA traffic sensitive pool.[23]

2. Optional Incentive Regulation Must Provide Sufficient Incentives for the Implementation of LEC Efficiencies.

The Commission tentatively concludes that the optional incentive regulation plan should incorporate earnings bands similar to price cap regulation.[24] However, because the Commission believes that optional incentive regulation is less risky than price caps,[25] it proposes that LECs be permitted to earn no more than 100 basis points over the authorized rate-of-return,[26] far lower than what price cap carriers can earn.[27] At the same time, the Commission proposes that the lower end of the earnings band for optional incentive regulation be set at 100 basis points

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[23] With regard to another eligibility related issue, although not mentioned in the NPRM, USTA assumes that a LEC may participate in the plan on an affiliated-company pooling basis. Such interpretation is consistent with both price cap regulation and Section 61.38 procedures.

[24] NPRM, ¶ 11.

[25] Id. at ¶¶ 9, 11, 14.

[26] Id. at ¶ 12.

[27] See Second Report and Order, 5 FCC Rcd at 6801-02. Including the effect of the sharing zones, LECs under price caps can earn up to 300 extra basis points with the 3.3% productivity option, and 400 extra basis points with the 4.3% productivity option.

below the authorized rate-of-return,[28] the same level as price caps.[29]

USTA agrees with the Commission that price caps are riskier for LECs than the optional incentive regulation plan. As discussed below, however, the Commission ignores the substantial risks that are inherent in optional incentive regulation and, as a result, has proposed an earnings range that provides far too little upside potential relative to those risks. In USTA's view, the Commission's proposal to allow LECs to earn no more than 100 basis points above the authorized rate-of-return (just 75 basis points over the current buffer zone[30]), while subjecting LECs to a loss of up to 100 basis points below the authorized level, is wholly inadequate and will discourage even the few eligible LECs from participating under the plan.

The risks of optional incentive regulation are substantial. When the LEC retargets to the authorized return level at the end of the two-year period based on historical data, there is a significant chance that the LEC will not reach its authorized rate-of-return if its costs increase in the subsequent period relative to demand. The

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[28] NPRM, ¶ 12.

[29] Second Report and Order, 5 FCC Rcd at 6802.

[30] See 47 CFR § 65.700(b).

likelihood that this will happen (i.e., costs grow faster than demand) increases as the LEC participates in the plan for multiple two-year periods. This is so because the longer that the LEC is covered by the plan, the more difficult it will be for the LEC to achieve further efficiency gains, and the LEC will receive little or no benefit from its prior gains once it retargets its rates back to the authorized rate-of-return at the end of the two-year period.[31] Additionally, the LEC's overall rate level will be frozen for two years during which the LEC will not receive any inflation protection.

Further, the rewards of incentive regulation, regardless of the level of the earnings ceiling, are limited. Under the plan, all benefits of efficiency gains, other cost savings and market stimulation ultimately flow to the customer. This is so because every two years, the LEC must retarget its rates back to the authorized rate-of-return based on historical cost and demand data.[32] In

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[31] See NPRM, ¶ 9.

[32] Id. In contrast, under price caps, LECs are permitted to retain their gains in perpetuity except to the extent that earnings over certain levels must be shared with customers .

other words, the more a LEC earns under the plan, the lower it must set its rates in subsequent periods.[33]

The Commission attempts to ameliorate the plan's risk/reward tradeoff by proposing that carriers be allowed to include known and measurable costs in their rate determinations at the time of their biennial tariff filings.[34] USTA strongly supports the inclusion of known and measurable cost <u>and</u> demand changes. However, the Commission's proposed application of known and measurable changes does not substantially reduce a LEC's risks. Under the proposal, a LEC could include known and measurable changes only to the extent that such inclusion would bring the LEC's rates up to 100 basis points below the authorized rate-of-return.[35] Under such circumstances, where a LEC knows beforehand that even with known and measurable changes its rates would be targeted 100 basis points below the authorized return, the LEC would have little reason to participate in the plan.[36] For this reason, the Commission

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[33] Even if the LEC leaves the plan after the two year period, it must reset its rates at the authorized return level. <u>See</u> NPRM, ¶ 26.

[34] NPRM, ¶ 14. The Commission also proposes to include exogenous changes as defined by the price cap rules. <u>Id</u>.

[35] <u>Id</u>.

[36] The likelihood of LEC participation in the plan under these circumstances would increase if the minimum earnings range (continued...)

should permit rates to be targeted to the authorized rate-of-return so long as the LEC can demonstrate that known and measurable changes, in the aggregate, would otherwise cause the carrier to earn 100 basis points below that level.[37]

In sum, the risks posed by the optional incentive regulation plan are real and substantial. While USTA does not believe that LECs under the plan should be permitted to earn as much as price cap carriers, the Commission's tentative proposal to allow earnings up to only 100 basis points above the authorized level is patently unreasonable.

The Commission seeks "recommendations for the appropriate level of earnings, expressed in basis points above and below the authorized rate of return, that carriers

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[36](...continued) was set 50 or 25 basis points below the authorized return, rather than 100 basis points below that level.

[37] The Commission seeks comment on what type of costs should be recognized as "known and measurable" NPRM, ¶ 14. As noted above, USTA believes that known and measurable changes should include demand as well as cost changes. USTA would define "known and measurable changes" as instances where there is an objective confirmation of the future event causing the cost or demand change (e.g., a signed contract or other documentation evidencing the future construction of a new transmission facility or the installation of a new switch, written notice to the LEC from a major customer for termination of service on a date certain.) Known and measurable changes would also include events that have already occurred, but are not yet normalized, such as where a major plant investment was made in the last quarter of the test period.

should be permitted to retain under the plan."[38] In light of the plan's risks, and the potential benefits accruing fully to customers every two years, USTA proposes that carriers be permitted to earn up to 200 basis points above the authorized level before having to retarget to the authorized return at the end of each two-year period. USTA believes that this earnings level represents a reasonable balance between risk and reward under the incentive regulation plan.[39]

3. **<u>The Pricing Flexibility Feature Should Incorporate A Rate Adjustment Factor at the End of the Two-Year Period.</u>**

The Commission proposes a pricing flexibility feature as part of the incentive plan that would include a "basket" and "service category" system similar to that of price caps.[40] Under the plan, within each two-year period, aggregate rates for each basket must remain unchanged, but

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[38] NPRM, ¶ 12.

[39] The Commission asks for comment on whether earnings over the upper limit should be subject to sharing requirements, as they are under price caps. NPRM, ¶ 12. USTA believes that sharing would introduce an unnecessary administrative complexity into the plan. In essence, under USTA's proposal there is 100% sharing with the customer above 200 basis points during the two-year plan period. Additionally, customers receive the full benefit of the lower rates when the LEC retargets to the authorized level at the end of the period.

[40] NPRM, ¶ 18. The baskets would include common line, switched traffic sensitive and special access. <u>Id</u>. Interexchange would not be included under the plan.

carriers may adjust rates within each service category by no more than 10 percent up or down during the period. Filings of rate adjustments that are within the prescribed limits would be permitted on 14 days' notice and would be presumed lawful.[41]

USTA supports the Commission's pricing flexibility proposal. The plan, however, provides no transition mechanism for retargeting the "flexed" rates to the authorized rate-of-return at the end of the two-year period. USTA believes that such a mechanism is essential in order to minimize rate churn during the retargeting process while preserving the benefits achieved by pricing flexibility during the incentive period. This is particularly important where the LEC had exercised pricing flexibility in order to meet competitive threats, or to better position itself relative to the rates of a neighboring carrier. Without a transition mechanism, the LEC's rates after retargeting would bear little relationship to its flexed rates at the end of the incentive period. In its original proposal to the Bureau, USTA generally suggested a rate adjustment procedure aimed at resolving this issue. The proposal would provide LECs with the ability to carry existing rate relationships into the subsequent tariff period, maintaining

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[41] Id.